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SUBJECT: BOTSWANA BALANCES BUDGET ON HIGHER DIAMOND EXPORTS

REFERENCE: 05 GABORONE 264

¶1. SUMMARY: The Government of Botswana expects to balance its budget in 2006, thanks to growth in revenues from the mining sector and a one-off payment from the old Southern African Customs Union agreement. Although Minister of Finance Gaolathe predicted 6 percent growth for the next two to three years and easing inflation, the private sector and politicians are not so confident. The large allocations to education and social services demonstrate that Botswana continues to have its fiscal priorities right even as it struggles to avoid budget deficits. END SUMMARY

GOVERNMENT FORECASTS SLIGHTLY SLOWER GROWTH

¶2. Botswana's economy grew at 8.3 percent in real terms during 2004/05, up from 3.4 percent in 2003/04. The increase derived primarily from the mining sector, which grew at 18.2 percent, versus only 0.2 percent the previous year. This change reflects the fluctuating nature of revenue flows from mining rather than significant additional revenue from a new mining operation coming on stream. The exchange rate adjustment also increased the Pula value of Botswana's mineral exports. The non-mining sectors turned in a less impressive performance, with growth slowing to 1.9 percent from 5.6 percent in 2003/04. Lisenda Lisenda, of the Botswana Institute of Development Policy Analysis, attributed this to a decline in manufacturing exports and a dip in tourism resulting from the prior appreciation of the pula.

¶3. Minister of Finance and Development Planning Baledzi Gaolathe forecast growth of 6 percent over the next two to three years. In order to reach that target, he said, the GOB must further eliminate barriers to investment, increase productivity and maintain a competitive exchange rate. With the latter challenge presumably met through the institution of a crawling band mechanism, government efforts will focus on attracting investment and increasing productivity. In an effort to chart a path toward economic diversification, the President appointed an Economic Advisory Council that should make recommendations by September.

¶4. According to Wayne Osterberg, CEO of Stockbrokers Botswana Ltd., however, 6 percent might be optimistic. In a March 23 conversation, Osterberg told Emboff that he was surprised by Gaolathe's estimate given the "gloomy" atmosphere in the private sector. This was consistent with the Botswana Confederation of Commerce, Industry and Manpower's (BOCCIM) description of the economy as "waning". High interest rates (businesses borrow at 17 percent) and rising prices are cutting into the historically large margins that lack of competition has afforded Botswana companies.

RECORD BALANCE OF PAYMENTS SURPLUS EXPECTED

15. Minister Gaolathe forecast a record surplus of P6.5 billion (\$1.2 billion) in the current account for 2006, driven by substantial export growth. The preliminary estimates for the balance of payments show a surplus in 2005 of P5.2 billion (\$0.95 billion), compared to a deficit of P232 million (\$42.2 million) in 2004. Exports of goods are estimated at P22.7 billion (\$4.12 billion) in 2005, a 31 percent increase from P17.3 billion (\$3.15 billion) in 2004. This 31 percent gain primarily reflects increased exports of diamonds, copper/nickel, soda, ash and beef coupled with increased world market prices and favorable exchange rate movement. Imports increased 17 percent from P13.4 billion (\$2.44 billion) in 2004 to P15.7 billion (\$2.85 billion) in 2005. Net outflows in the financial account were P880 million (\$160 million), associated primarily with pension fund portfolio diversification. As of November 2005, Botswana's foreign exchange reserves held at P34.7 billion (\$6.2 billion), representing an increase over 2004 of \$500 million. These reserves were estimated to represent 27 months of import cover, an increase from 22 months in 2004.

INFLATION UP, DESPITE PREDICTIONS

16. Botswana's inflation rate averaged 8.5 percent in 2005, up from 7 percent in 2004. Gaolathe attributed this to depreciation of the pula and rising prices in the energy and telecommunications sectors. He expected inflation to slow in 2006. (The Bank of Botswana's target range for inflation is 4 - 7 percent.) The Government's Central Statistics Office, however, reported that year-on-year inflation had reached 16.6 percent in January and edged up to 17 percent

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in February. The institution of school fees in January contributed significantly to this change -- education costs increased 140 percent. Rate hikes by Botswana Telecommunications Corporation of up to 100 percent for off peak, domestic calls and 50 percent for peak-hour domestic calls helped drive up transport and communication prices by 20 percent. Other areas of high inflation included energy (26 percent), alcohol and tobacco (17 percent) and food (12 percent). To offset inflation, the budget proposed an 8 percent across-the-board raise for all public employees.

GOVERNMENT ANTICIPATES BALANCED BUDGET

17. Minister Gaolathe presented before Botswana's National Assembly a total proposed budget of P23.22 billion (\$4.2 billion), which would result in a budget surplus of P922.5 million (\$168 million). Mineral revenues constitute P11.39 billion (\$2.07 billion) or 47 percent of projected total revenues of P24.14 billion (\$4.38 billion). Customs and excise receipts are expected to increase by 55 percent from the previous year to P5.30 billion (\$0.97 billion) due to a one-off payment from the Southern Africa Customs Union Revenue Pool. The Minister described this as "the major source of revenue increase." Without this boost in customs revenues, the budget would be P968 million (\$176 million) in the red.

18. After decades of balanced budgets, the mounting costs of HIV/AIDS are testing the government's finances. Last year, the Government expected to run its fourth consecutive deficit budget but ended up with a surplus of P574 million (\$104 million) (reftel). This resulted primarily from the adjustment to the exchange rate mechanism and favorable shifts in world prices for Botswana's mineral exports. The struggle to balance the budget is likely to persist as the number of Botswana enrolled in treatment programs rises.

19. In the proposed budget for 2006/07, Botswana continued to allocate a preponderance of funds for social development. The two ministries with the largest allocations were

Education, which accounted for 27 percent of the recurrent budget, and Local Government, which includes various social welfare programs, at 14 percent.

JOB GROWTH WEAK

¶10. Despite the strong growth numbers for 2004/05, Members of Parliament have recently expressed concern about the direction of the economy. During the previous session of parliament in November-December 2005, several ruling party members opined that the economy was in trouble and pleaded with the President to devote more resources to that problem. That apparent incongruity results from the fact that Botswana's growth is driven by the capital-intensive mining sector. The non-mining sectors, which are more able to create jobs, slowed significantly. Accordingly, formal sector job growth slowed from 3.1 percent last year to 2.8 percent this year, just ahead of the population growth rate of 2.4 percent.

¶11. Minister Gaolathe also announced his intention to present for discussion before the National Assembly a draft National Policy on Incomes, Employment, Prices and Profits. The draft would provide for minimum wages for domestic and agricultural workers and would formalize the objective of linking wage growth to productivity. Elaborating on the latter point, Gaolathe emphasized "concerns about our workers' unsatisfactory attitude toward work" and poor customer service as barriers to investment.

WANTED: INVESTMENT

¶12. Minister Gaolathe underscored the importance of attracting investment, including foreign direct investment, to accelerate economic growth. He listed delays in land acquisition, the shortage of serviced land and the high cost of servicing unimproved plots as barriers to investment. Botswana's International Financial Services Center provided no encouragement for hopes that it had gained momentum in attracting investors. During 2005, the IFSC had to de-list seven companies for failure to start or continue operations and approved only five new applications.

LOCALIZATION OF TOURISM SMES

¶13. In an apparent attempt to address the perception that foreign firms dominate the tourism sector to the detriment of Botswana, the government announced its intention to

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reserve several types of small and medium tourist operations exclusively for citizens. During the ensuing debate, Minister of Environment, Wildlife and Tourism Kitso Mokaila accused tourism companies of mistreating their workers and importing young and inexperienced managers, overlooking better qualified Botswana. Mission will address this issue and its possible ramifications for the important tourism sector septel.

PRIVATE SECTOR RESPONDS POSITIVELY TO BUDGET

¶14. The Botswana Confederation of Commerce, Industry and Manpower issued a press release praising the proposed budget. After a "turbulent" 2005, BOCCIM hoped the increased government spending would "kick start [Botswana's] waning business prospects." It welcomed the government's decision to keep VAT at 10 percent and exempt some additional basic food stuffs but decried the lack of a timeline for the implementation of the privatization master plan. Although Transparency International again ranked Botswana Africa's least corrupt country in 2005, BOCCIM asserted that corruption is on the increase and demanded greater transparency in government procurement.

COMMENT

¶15. Despite the regressive introduction of school fees in January of this year, the 2006/07 proposed budget demonstrates the kind of fiscal responsibility that helped Botswana become a middle-income country. While the continued investment in education and social services should pay-off in higher productivity in the long term, low productivity, high interest rates, and rising prices pose significant obstacles to growth and diversification in the short term.

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